

Political Risk and Regulatory Risk: Issues in  
Emerging Markets Infrastructure Concessions

Gustavo Ferro  
Working Paper N° 15

(August 2001)

CEER  
Centro de Estudios Económicos de la Regulación  
Universidad Argentina de la Empresa  
Lima 717, 1° piso  
C1053AAO Buenos Aires, Argentina  
Telephone: 54-11-43797693  
Fax: 54-11-43797588  
E-mail: [ceer@uade.edu.ar](mailto:ceer@uade.edu.ar)  
<http://www.uade.edu.ar/economia/ceer>.

(Please see the back pages of this paper for a listing of current working paper titles and subscription ordering information).

The Centro de Estudios de Economía de la Regulación (CEER), is an organization engaged in the analysis of the public regulation of utilities. The CEER is supported by the World Bank, the Regulatory Agencies of the Public Utilities of Water and Electricity of Argentina, and the Universidad Argentina de la Empresa (Buenos Aires), where the CEER works.

CEER's Authorities:

Ing. Eduardo Cevallo, President Ente Tripartito de Obras y Servicios Sanitarios. Lic. Enrique Devoto, First Vicepresident Ente Nacional Regulador de la Electricidad (ENRE), Dr. Antonio Estache, World Bank Institute, Dr. Carlos Newland, Rector Universidad Argentina de la Empresa (UADE).

Director: Dr. Diego Petrecolli

RESEARCHERS: Lic. Diego Bondorevsky, Dr. Omar Chisari, Lic. Gustavo Ferro, Dr. Diego Petrecolli, Dr. Martín Rodríguez Pardina, Lic. Carlos Romero, Lic. Christian Ruzzier,.

RESEARCH ASSISTANTS: Lic. Iván Canay, Lic. Mauricio Roitman, Lic. Mariano Runco

CEER Working Paper Series  
Political Risk and Regulatory Risk: Issues in Emerging Markets Infrastructure Concessions  
Gustavo Ferro  
Working Paper N° 15  
(Date: August 2001)  
JEL N°: D4

Abstract: Political and regulatory risks, cause damage to countries and investors because of investment diminishing. When investments take place, those could increase services prices. Present work has as its objectives to characterise theoretically the problem, to study existent measures to face it, to know the available instruments to deal with it, and to draw some general conclusions on political and regulatory risks, and some specific conclusions referred to infrastructure concessions. The article is limited to the study of opportunistic behaviour or governments.

Affiliation of the author: Gustavo Ferro, CEER/UADE, [gferro@uade.edu.ar](mailto:gferro@uade.edu.ar)

CEER  
Centro de Estudios Económicos de la Regulación  
Universidad Argentina de la Empresa  
Lima 717, 1° piso  
C1053AAO Buenos Aires, Argentina  
Telephone: 54-11-43797693  
Fax: 54-11-43797588  
E-mail: [ceer@uade.edu.ar](mailto:ceer@uade.edu.ar)  
<http://www.uade.edu.ar/economia.ceer>.

# Political Risk and Regulatory Risk: Issues in Emerging Markets Infrastructure Concessions

**Gustavo Ferro<sup>1</sup>**

## I-Introduction

In recent years, and after having recovered from the Debt Crisis, capital flows had taken impulse from developed countries, towards emerging markets. These flows are integrated partly from Foreign Direct Investment (FDI), some of them managed to take over and capitalise infrastructure sectors. Movement towards privatisation of infrastructure areas in less developed countries, had been one of the capital attraction elements (“push”), concomitant with others of the same character, and with expulsion factors from developed countries, starting from a decade of low international interest rates (“pull”).

Investment in infrastructure sectors has some peculiarities regarding other economic sectors. Most remarkable elements for the topic in study, are their high proportion of sunk investments, and in some cases, the characteristic of being natural monopolies subject to regulation. Investments in infrastructure are typically big, long term, relatively irreversible and specific, and dependent on sales in domestic markets. Also, intervention of governments in the operation of such projects is exercised through direct provision, the prices regulation or return rates, regulation security rules and quality prospects. Infrastructure assets are frequently considered as strategic, and they are prone to be expropriated when faced with political changes.

Current times are a relatively friendly period for business at international level, but such a characteristic does not have to be projected without criticisms into the future. The presence of sunk investments, and of sectors subject to regulation, are a temptation for direct expropriations of sunk resources, or indirect type expropriation through regulation. History registers a peak of first type events by the middle of the 1970s, and a practical disappearance since the 1980s. There are diverse mechanisms to protect the investments. Through the capital markets, the investments are priced in consequence. Political and regulatory risk, nevertheless, does not register the existence, so far, of cardinal mechanisms of measurement, but of ordinal ratings of countries. Derivatives instruments are also being developed to cover the eventualities already pointed out. Insurance markets (private, public or international organisms), by means of guarantees or collateral schemes with co-insurance mechanisms, has developed covetaking against the type of disasters referred. There are also instrumented bilateral treaties for investment protection (more than 1200, and very recent in high proportion), and there are international arbitration courts that though still not constituting supranational courts, they provide a form of making complete contracts, although the solution is through an agreement and not by imposition of an award (there is absence of enforcement mechanism, because the non delegation of national powers).

---

<sup>1</sup> Professor/Resercher of Economics, Universidad Argentina de la Empresa (Buenos Aires, Argentina). E-mail: [gferro@uade.edu.ar](mailto:gferro@uade.edu.ar); [gferro@elsitio.net](mailto:gferro@elsitio.net).

Between the possible contractual forms to privatise, a possibility is a Concession. This does not transfer the property of the assets (the "net") to the private sector, but only the operation and maintenance of the existent assets to the moment of privatisation, and could set goals of net expansion. That is to say that the concessions comprises two businesses from the point of view of the concessionaire: to operate and to maintain the service, and to build net expansion. At the expiration of the concession, assets should be reinstated by their owner, the licensor. The international experience with concessions of public services shows failures and contractual renegotiations in many of the cases. A recent work from the World Bank, takes advantage of empirical evidence accumulated in this respect, and established statistical regularities that indicate which design factors involve higher probability of renegotiations. In Guasch (2000), based on the analysis of more than 600 concessions in the infrastructure sector, it is noticed that the design of the concession is the strongest determinant in the performance and the conflicts, demands, renegotiations, distributive impact, incomes, efficiency, competition in the sector, market share and its impact, incentives -in a strong sense-, and performance. Incidence of the renegotiations of concessions is extremely high. More than 60% of the concessions were renegotiated during the first three years of having been granted. Common problems are poor designs of the concessions, contracts and regulatory rules not clear enough, ongoing changes of the rules of the process, and inappropriate interpretations of contracts (Guasch, 2000).

Political and regulatory risks damage countries as well as investors. Moran (1999), discusses the definition of political and regulatory risk, including traditional political risk (as political violence, constraints to the conversion and currency transfer, or expropriation), regulatory risks (as application of adverse rules and/or arbitrary changes in the rules), and risks of quasi-state acting (as like non-compliance of procurement agreements from government or quasi-governmental organisations (Moran, 1999).

Present work has as its objectives:

- 1) To characterise problems of political risk and regulatory risk theoretically.
- 2) To study existing measures of political risk and regulatory risk.
- 3) To know available instruments to face them: 3-1) "Self-Aid" of the investment recipient countries, following Moran's (1999) terminology, 3-2) International Law, international agreements and international arbitration courts, 3-3) Insurance, Guarantees and co-insurance of the States and international organisms, as well as of the private sector.
- 4) To find some conclusions on political and regulatory risk grounds, and particularly, referred to infrastructure concessions.

The essay is limited to political and regulatory risk when the responsible is the government action: opportunistic behaviours of the companies are not analysed.

After this Introduction, there are four more sections, referred respectively to the theoretical concepts, the existent measures, the available instruments and concluding remarks.

## **II-Theory: Opportunism, Political Risk and Regulatory Risk**

To characterise political and regulatory risk, and their influence in the infrastructure concessions, a way of going from general to particular, is to treat the problem as one of opportunism, in the line of the “economy of the transaction cost” (Williamson, 1989 and 1975). A concession process from privatisation and along the contract life, could be understood as a dynamic game with incomplete and imperfect information. The nodes of information are the key events of the life of the contract (bid, instances of ordinary revision, and extraordinary instances that trigger renegotiations or revisions). In each one of them, investor is subject to potential opportunistic behaviours on behalf of the licensor (and vice versa). Opportunism can come from both parties in the contract. Specifically, this essay will concern opportunism coming from potential moves of the licensor. Diverse mechanisms exist to solve opportunistic behaviour, and many of the risks are valued by the market, but when they surpass certain threshold, there is the hazard of transactions disappearing.

Political and regulatory risks can be defined as shocks on the profitability of projects that derive from some government action or inaction, whilst any change under market conditions occur. They are also different from acts of nature, accidents and crimes. The delimitation criteria is very ambiguous, and the definition of political risks can be very wide or very narrow from the point of view of the party who requires a covetaking. Investments may need to cover almost all conceivable eventualities, or to face the possibility that their rights could be infringed. There are sometimes difficulties to separate political risks from commercial or quasi commercial ones (Moran, 1999).

Infrastructure projects are particularly sensitive to government action or inaction, more than to changes of economic conditions in the market. They are usually regulated monopolies. They are usually considered essential services and are very exposed to politic scrutiny and public attacks. They use important sunk resources with long periods of repayment. In some cases their suppliers or key clients are state dependencies. When a foreign investment takes place, it yields the necessity of conversion and remission of foreign currencies that governments can control. Infrastructure projects can be the target of public claims, political, social or environmental messages, and regulator opportunism (Moran, 1999).

Political and regulatory risks can be divided into three overlapping categories:

Traditional political risks: acts of opportunism, as expropriation, changes in convertibility of the currency rules and rules for transfers of foreign currencies, absence of policies to eliminate the political uncertainty and political violence. The risk of expropriations is that of nationalisation of the assets, or even the procedures of a company in an arbitrary or discriminatory way, without payment of a fair compensation. An alternative is the “creeping expropriation” where the procedure is not direct, but where actions are carried out to force the investors to abandon the project, to sell to local partners, or to renegotiate in unfavourable terms the original agreement. The risk linked to the inconvertibility of the currencies has to do with the controls of exchange, and of transferring of foreign currencies among countries. Into traditional political risks, those of political violence include wars, revolutions, insurrections, terrorism, or sabotage. They can come from the host government inability to defend the investor, or from the investor direct attack.

Regulatory risks: they arise from the application and execution of regulatory decisions or of absence of decisions, changes of rules of the game during the life of the project, interpretation of vaguely specified rules, discretion, regulatory decisions influenced by the political and social climate, absence of enforcement procedures. Regulatory risk comes from the possibility that the authorities affect prices, quantities or services, altering company's profitability, exercise profitability direct controls, or change the rules that govern prices or benefits of a natural monopoly or its application.

Non compliance risks from government or state entities, of supply agreements and procurement purchases. They can come from the lack of performing of buyer obligations, or of absence of enforce from the minister or monitoring agency, as well as inability to comply due to flaws in forecasts or managerial inefficiency.

Few formal intents have existed to model opportunist behaviour. The key features seem to be different time horizons and social discount rates, among companies of public services, consumers and political authorities, together with collective action conditions, opportunism that allow political authorities not to face the consequences of actions that lead to long term deterioration of services (Moran, 1999). There is a more dynamic explanation of the sources of political and regulatory risk, that comes from "Obsolescing Bargain" pattern, on the evolution of the relationship business-government. The theory, is an explanation of how relative power in the negotiation is changing between the host country and the firm in a systematic way, along the life of the agreement. It is based on:

- 1) The investor and the host countries pursue divergent interests.
- 2) They exchange information through talks.
- 3) They intermittently negotiate the initial terms of entrance of foreign direct investment (FDI), as well as a variety of operative topics.
- 4) There are credibility problems and commitments that appear with FDI, but they would not be present for domestic investments.

Once the investor sank resources, he becomes a hostage of guest government. Changes in the level of commercial risk associated with the project and changes in the evaluation of the benefits that investors are gaining, lead to both parts to an unstable relationship. Investors (and those who finance them), will not commit resources to a project unless they receive a compensation against the initial uncertainties they were exposed to. Authorities agree on those terms to attract investments, but as far as the project turns out to be successful, they, or their successors could not want to continue compensating the investors with the same generosity, once the risk and the uncertainty initials have vanished. There are strong incentives to renegotiate the contracts: the problem is one of "time inconsistency". There is the impression that the contracts of investments for early participants in an opening process to FDI, contain terms that reflect the lack of available alternative investments for the guest country that should disappear when more potential investments appear. Negotiations can be loaded with pressures of all kinds. There are some elements that have proved to be good predictors of vulnerability to the renegotiations (Moran, 1999):

- 1) Companies with relatively small sunk capital (until US\$ 50 million), can retire them with higher probability without being trapped, regarding companies with big fixed investments.

- 2) Those that use more dynamic technology have bigger negotiation power, than those which use more mature and stable technologies.
- 3) Companies whose local products exhibit more publicity and distinct features, are more immune to guests countries' demands, than those companies whose products are sold as bulk homogeneous products.

From a historical point of view, the concept underwent transformations:

- 1) Until 1960s: although were took into account the manifestations of political risk, there was not neither an elaborated concept, nor a precise consciousness of political risk.
- 2) The 1970s: awareness at companies' level of the risks generated by ideological questions (Marxism and Nationalism).
- 3) Since the 1980s: the concept turned scientific and professional, and quantitative methods of risk determination, the probabilistic interpretation of the political risk, and the systematic use of the concept arise from those points of view both at companies and professional levels.
- 4) Since the 1990s: the concepts are revamped with contributions from other disciplines.

As a financial phenomenon, political risk is an unpredictable demand made by foreign states or the society, on assets, returns or available currency for the shareholders of investments of international companies. Some difficult to forecast discontinuities happen in the atmosphere of business.

Definition of political risk can be extensive or restrictive. Extensive definition includes acts of all kinds, without caring where they were originated. From this perspective, sources of political risk are the governments, and also the social instability. Haendel (1985), mentioned by Kanga Wafo (1998), defines political risk as unexpected changes in political factors that affect relative prices of production factors, goods and services, caused by the actions and reactions of governments and other groups, inside one country, and among countries. Restrictive definition, embraces only political uncertainty strictu sensu, originated exclusively by state activities. Also, only political unpredictable events are counted in this perspective of political risk. Both, extensive definition and restrictive ones are descriptive and not economic. Kanga Wafo (1998) uses Haendel's more technical definition: "the risk or probability of occurrence of some political events that will change the perspective of the benefits of a given investment". The biggest political risks that concern foreign investors in infrastructure sectors, have to be with conditions specified in the contracts, concerning investors' immunity regarding the uncertainty of the local economy, egalitarian treatment of national investments and free profit repatriation, as well as violations to contract spirit, expropriations, regulations that limit the reach, or interpretation, or the exact provision application.

In the specific case of public utilities concessions, the conditions of the problem make them permeable to political risk, as a result of opportunist behaviour in a context of bounded rationality, possible in transactions where there is high assets specificity (a sunk net), extensive periods of concession, with periodical revisions and possibility of re-negotiation of initial conditions, and all above-mentioned issues, in an uncertain environment.

In the economic analysis of the contracts, different approaches can be distinguished according to Williamson (1985), combining:



- 1) Assumptions about the contracting parties behaviour.
- 2) Transactions attributes considered of economic importance.
- 3) The degree of courts resource to solve controversies (point not treated here).

A combination gives the traditional neo-classical approach, another yields the economy of the transaction cost, in the line of Williamson, Coase and Simon, and a third one opens the door to the social engineering. These three components, in the combination presented in Table 1, configure the supposes of the transaction cost economy.

Table 1: Transaction Cost Economy	
Conduct	Bounded Rationality Opportunism
Transactions Attributes	Specificity if Assets Uncertainty Frequency
Courts Resource	Not Treated here
Source: Williamson, 1989.	

## II-1 Behaviour

On agents behaviour, economy of the transaction cost supposes that bounded rationality and opportunism could exist. The former recognises the limits of the cognitive competition. The later replaces honest and straight pursuit of self interest, for an approach that includes dishonesty or negligence among other possible behaviours.

Rationality in its strong form leads to maximisation, in semi-strong form to bounded rationality and in the weak form to organic rationality. The tradition of maximisation (neo-classical economy), doesn't recognise all the pertinent costs. Arrow-Debreu's contingent claims market is its more ambitious version. Under the assumption of organic rationality, on the other side, there are institutions that are not planned: ignorance and spontaneity work with more efficiency in the achievement of certain goals, instead of knowledge and planning (for instance, language construction, adoption of a merchandise as a mean of payment or exchange).

Bounded rationality supposes that the economic agents are "intentionally rational only in limited way". The economy of the transaction cost recognises that rationality is limited. The study is encoutakingd towards institutions when constraints on cognitive competition is admitted. Understanding is the scarce resource. Bounded rationality in the economy can affect decision processes (costs planning, adaptation and monitoring of the transactions), and government structures (which are more effective?, for what kind of transactions?).

Orientation toward self-interest in the strong form (economy of the transaction cost), implies the acceptance of opportunism like a possible behaviour, in the semi strong way is the simple search (honest, straight and loyal) of self interest, implicit in the neo-classical approach, and in their weak form, obedience. Problems of opportunism would disappear if individuals were entirely open and honest, or if it could be shown full subordination, and obedience.

Opportunism is understood as the search for self interest with deceit. It includes lie, robbery and deceit, negligence or deliberate omission; active and passive ways, and ex ante and ex post types. For case, ex ante and ex post opportunism are adverse selection and moral hazard problems in the insurance market. In general, opportunism refers to incomplete or distorted revelation of information, specially premeditated efforts to mistake, to distort, to hide, or confuse. Principals and third parties (referees, courts), face problems of ex post inference. If opportunism did not exist all behaviour could be governed by rules.

Reciprocal opportunism or anticipation opportunism, is not the only lesson that can be learn from the assumption that human beings are not fully reliable. Even more important, transactions subject to the ex post opportunism will benefit if they contain ex ante appropriate safeguards. Incentives can be re-aligned, or government structures can be elaborated. Above-mentioned assertions, only affirm that some individuals are sometimes opportunists, and that their intentions are rarely transparent ex ante. In consequence, efforts of ex ante selection are made, and ex post safeguards are created. Otherwise, more opportunists participants will be able to explode excessively those who have more principles.

Table 2: Combined Problems of Opportunism and Bounded Racionality.

		Bounded Rationality Condition	
		Absent	Admitted
Opportunism	Absent	Contractual Utopia	General Clause Contracts
	Admitted	Comprehensive Contract	Huge Contractual Difficulties

Source: Williamson (1985).

The world of simple pursuit of self interest is for the neo-classical man. The problems of economic organisation depends on technological grounds without a problematic behaviour imputable to non-compliance of rules by human actors. Obedience, at last, is the behaviourist assumption of the social engineering: economic processes are almost reduced to technical manipulations (Williamson, 1985).

## II-2 Transactions Attributes

The main attributes of the transactions, in the context of present discussion, are: specificity of assets, uncertainty and frequency.

Regarding specificity of assets, important for contracting is if assets can move or not. There can be distinguished four types of specificity: of localisation, of physical assets, of human assets and of dedicated assets. The specific assets have little alternative value.

About uncertainty, that of strategic type is attributable to opportunism, and Williamson (1985), called it the flame behaviourist uncertainty. It is bound to unique events. Surprising movements often raise complex answers. Behaviourist uncertainties would not outline contractual problems, if the transactions are free of exogenous interferences. Does the easiness of execution of the contracts disappear as soon as need of adaptation arises? (discretion against not foreseen events). Should bad adaptations be tolerated to change of contractual circumstances? Could it be

elaborated a structure of governance that attenuates such behaviourist uncertainties? The interaction effects between uncertainty and specificity of assets, is important for understanding the economic organisation (Williamson, 1985).

In connection with frequency, an initial bid only begins a contracting process in movement. A full evaluation, requires the scrutiny of contract execution and ex-post competition in the interval of contract renewal.

The full effectiveness of ex post competition, depends on the fact that the good or service in question is supported by durable investments in human or physical assets, specific of certain transactions. *Ceteris paribus*, exchange relationships that rest in personal trust will support bigger tensions, and they will show bigger adaptability.

Table 3 summarises the main implications: for contractual theory, the presence of bounded rationality and opportunism implies that wide contracting is limited (contracts will be always incomplete), and the contract understood as promise is naive. The consequences for economic organisation are that exchange will be facilitated with sequenced transactions and with adaptive decisions, and when spontaneous safeguards or contingents are generated with ability.

Table 3: Behavioural Assumptions Implications for the Organisation		
Behavioural Assumptions Implications	Bounded Rationality	Opportunism
For Contractual Theory	Ample Scope Contract is Almost Impossible	Contract as Commitment is not Credible
For Economic Organisation	Exchange will be facilitate if the timing of adaptable decisions adopts a particular way.	Exchange will require spontaneous and or subtle safeguards.
Source: Williamson (1985).		

Economic research, carried out so far on the relationship between FDI and political risk, spreads to agree that FDI is determined by the offer side (multinationals), assuming infinitely elastic demand in less developed countries. Relationship between FDI and political risk also can be seen from another perspective: that of the host country. In the standard neo-classical pattern, capital goes from more developed countries to less developed ones, searching the biggest relative yields in last ones, where capital is scarcer and marginally more productive. But most of FDI empirically takes place among developed countries. An explanation to this apparent paradox, is the fact that in less developed countries, political uncertainty is higher. So, if they want to attract FDI, they should make efforts to reduce political risk. In the past, FDI went to extractive industries, as long as then began to direct to industry and services. Their participation in Western Europe and United States has grown, and the origin of the firm, before practically concentrated in North American and Britain, had expanded to other countries of Europe and New Industrialised Countries. Before monopolised by big firms, host countries have been friendlier to FDI than in passed periods, and they have settled down competition among countries to attract it. That FDI faces political risks almost exclusively in less developed countries, denotes the fact that most of international investment rules, as well as the public and private forms of insurance, are thought for those countries, and indexes of political risk are exclusively conceived for them (Kamga Wafo, 1998).

Manifestations of political risk include:

- 1) Constraints to FDI entrance: constraints to the proportion of company shares that a foreign investor can possess, on the kind of companies that can possess foreigners, or over the property.
- 2) Systems to control FDI flows: prohibitions in certain selected industries, vague approaches of official approval, high taxes and weak incentives, rules of national content requirements.
- 3) Limits on foreign currencies transfers: limits to capital and profits repatriation, delays for repatriation, limits in the amount of repatriation, foreign currencies controls.
- 4) Government direct intervention: price controls, prices setting for natural resources exploitation, regulation of monopolies, wide sector of state owned companies.
- 5) Social uncertainty: fragile political structures, weak level of society organisation, corruption.
- 6) Political violence: crime rate, blows, civil wars, civil disobedience, riots.
- 7) Government inability: inability to regulate the economy and to make reforms.
- 8) Turbulent reactions at international organisms presence.
- 9) Lack of commitment toward international environmental and labour rules.
- 10) Turbulent reactions to foreign investors in the last five years: lack of commitment with bilateral rules of investment, subtle expropriation of earnings.
- 11) Hostile attitudes of elite and society toward FDI: hostile declarations of parties, hostile programs.
- 12) Hostile attitudes toward foreigners: physical violence, intolerance toward foreigners or constraints on the immigrant work.
- 13) Host countries resistance to reveal valuable information: lack of transparency, secret in most of the political and economic decisions.

Traditional political risk was very specific, but contemporary risks are more diffuse: there are not formal taking of the property, but they are reflected in the way regulatory powers of the governments -or they omissions-, are used. Foreign investor is subject to a group of influences on the normal operation of his company. They can come directly from government, from local political cycle, imitation of foreign developments, or ONGs pressure. Visible form of risk is that the government reports prices or other obligations contained in laws, licenses or contracts. They can include rates and tariff rules (environmental, sanitary, social, preferential provision, prohibition of service cuts, political around labour, requirements of economic acting). The risks can come from central government, subnational levels, of non state actors or paraestatal, and even supranational actors. Risk can come from regulatory inefficiency of the State, regarding its responsibilities in a privatisation and liberalisation atmosphere, with persistence of monopoly net industries. Also, investors in infrastructure can be tied to long term contracts of input provision, and provision by public sector that can be subjected to political pressures. If legal system is weak and justice faulty, the problems are bigger. Contemporary political risk, has to do with the exhibition of infrastructure projects, to policies with regard to taxes, permits and state aid (Waelde, 1999).



### III-Measures of political risk

Surge of the concept in the economic literature, is bound to political events of the 1960s, when new independent countries tried to solve its lack of capital, taking it of multinational companies. Marxist and nationalist doctrines, intellectually influenced nationalisations and political control takings of multinationals companies activities. In the 1960s the problems of confiscations, expropriations and nationalisation turned to be critical for companies with international operations. Economic literature studied it mostly in conceptual models of relationships between host countries and multinational companies. After the fall of the shah Reza Palhevi of Iran, political stability was incorporated to the previous discussion. Studies arose to generate methods, or approaches to determine political risk technically. One of the first works (Rummel and Heenan, 1978, mentioned by Kamga Wafo, 1998), tried to translate political uncertainty in probabilistic terms. Another intent, was to generate a Business Environment Risk Information Index (BERI), like a quantitative guide to generate political risk grades. This generated qualifications on the base of external experts' judgement and appreciation, on a group of fifty factors that affect business environemnt. During the 1980s, the Political-Risk Services Evaluation System (PRS) was used. More recently, there were new efforts to evaluate political risk and to integrate it in companies' decision making, as well as the use of variables of economic policies, in political risk determination. There are numerous approaches to assess political risk, including decision trees, actuarial techniques, or statistical decision theory. In most of the cases, a mixture of subjective and objective approaches are used to analyse and to determine the political environment of a country. The objective type approaches assign importance to methodological solutions and procedures, to determine political risk. Their orientation is formal. A subjective focus makes use of human criteria, intuition or experience to predict the evolution of political atmosphere (Kamga Wafo, 1998).

The classic subjective approach include three methods: Grand Tours, Old Hands and Delphi.

- 1) Grand Tours: they join general impressions in a preliminary investigation of the market, or in an inspection tour of representatives of the company, including contacts and interviews with local actors. Their main problems are uncertainty, and excess of selective information.
- 2) Old Hands: companies try to acquire knowledge and diplomats' information, journalists, businessmen or expert consultants. It is tried to know judgements about leaders' personality and objectives, the strengths and weaknesses of competing political groups and the probability of new legislation. It is not systematic, and is based on outsiders judgements.
- 3) Delphi: they are more elaborated, and constitute a systematic way of collecting and ordering human experience and judgement. First, they try to identify selective elements that can influence the political destiny of a nation. Then, a wide group of experts is interviewed to give a range or to consider the importance of the elected factors in the country in consideration. Answers are compiled, and a list of control of the variables is elaborated. Then, they are added in a synthetic index. There are problems in the design of the partial indicators and in their aggregation process.

Among the objective approaches, highlights the econometric techniques of multivariate analysis. It is useful when data is quantifiable. They are good to predict future political tendencies on the base of historical information, and to describe in a more complete way underlying relationships

that affect the state of the nation. Their biggest difficulty is related with the inherently complex nature and subjective character of the phenomena. In general judgements and interpretations should be added on the results.

In more recent decades, measures of political risk have been developed. There are two general classes:

- 1) Wide indicators that make use of all available information of political variables.
- 2) Indicators that emphasise a specific variable, as democracy, political violence or government's stability, and they generate a partial political image.

One of the most used general indexes, is BERI (Business Risk Service Index). There socio-political changes are measured with the Political Risk Index (PRI), and they only constitute a part of country risk determination. The other components are the Operations Risk Index (ORI), and the R-factor, that measures risks of profit remittances and capital repatriation in convertible foreign currencies. The three measures are taken to a synthetic recommendation: the Profit Opportunity Recommendation (POR). Qualitative judgements are included in the determination of PRI and ORI. In PRI, ten elements are used to assess threats to stability:

- 1) Two external causes: dependence and/or importance of a bigger hostile power, and negative influences of regional political forces.
- 2) Six internal causes: fragmentation of the political spectrum and the factions power, fragmentation for linguistic groups, ethnic and/or religious, and the power of those fractions, coercive measures required to retain the power, mentality (including xenophobia, nationalism, corruption, nepotism, disposition to negotiation), social condition (including population's density and wealth distribution), and organisation and strength of radical left groups.
- 3) Two symptoms of political risk: social conflict (including manifestations, strikes and street violence), and uncertainty (non constitutional government changes, murders and guerrillas' war).

The measuring of political risk is made in four interrelated steps. First, present conditions of the first eight causes are qualified (0, the worse; 7, better). Then, they are qualified with the same range, adding the assessment of last two symptoms at present time. Maximum score, given to a country without political risk is 70 (first subtotal of BERI system). In second term, one or more of the causes can have a positive impact on the total grade. They can be used 30 points there in discretionary form. Typically, +20 points are assigned to a low risk country, +10 to moderate risky country, and 0 to a prohibitive risky country. Second subtotal has then a maximum of 100 points. In the third step, five and ten years predictions are made: points achieved up to this moment serve as a basis for future changes. Fourth step is the construction of a political risk index. From experience, four categories of countries are extracted: 70 up to 100 points are low risk countries, 55 to 69 points are considered moderate risk countries, 40 to 54 points are high risk, and if they are between 0 and 39 points, risk is considered prohibitive.

Another systematic indicator of political risk is the one that WPRF (World Political Risk Forecasts) provides. It is based on different premises that BERI, and uses different methods and grades. It is based on the Prince Model System. It uses the actors of a political system. A group of three to five experts, estimates the capacity of the main individuals, groups and institutions to

affect political risk in a country. Actors can be domestic or foreigners. Each one is qualified according to: Support, Neutrality or Opposition, Degree of Certainty (1, smaller; 5 bigger), Range of Power (1, smaller; 5 bigger), Degree of Importance (1, smaller; 5 bigger). Then, a probabilistic value is generated and used as above-mentioned input.

Other measures are those of Frost and Sullivan, International Country Risk Guide (of International Report), and those of Institutional Investor. As their bigger defects, they appeal to last actings to estimate future results, and that isolated events that can have a strong impact on operations and profits of companies.

They also exist partial political indexes. "Transparency International" publishes its Corruption Perceptions Index annually, and elaborates a range of countries with its levels co corruption perception, coming from business, political analysts and the public.

New approaches of integrated determination of political risk have been developed in a process of capital budget. They are:

- 1) To adjust future prospective cash flows of the project with expected losses attributed to political risk.
- 2) To measure political risk on a FDI, as the value of a insurance policy that reimburses all resulting losses of an event or political events, incorporating stochastic and evolutionary aspect of the political risk explicitly, as well as the sequence of political events in the rating.
- 3) To use the asset valuation theory, specifically for expropriation risks. If the expropriation probability depends on the results of the project, the appropriate rating technique is contingent claims analysis.

Investors that plan to enter into an industry, need to consider not only average political regime in host country, but also regime stability in the future. Political stability is analysed with macroeconomic indicators, or risk measures based on manager's perceptions. Henisz and Zelner (1998), argue that analysing the credibility of the own governments, and examining feasibility of political changes, important additional information is provided for investors. Specifically, they consider as important information to add to the traditional approach:

- 1) Structure of the political system and the consequent credibility of political power commitments.
- 2) Probable extension of lobby activities that can alter policy changes likelihood, in a shape harmful or favourable to investors.

Most of political risk problems' conventional measures, are related with the lack of attention on the political systems that undergo measuring. A prospective measure would examine last tendencies of macroeconomic attachés, and managers' perceptions of risk, but more than to extrapolate direct conclusions from these tendencies, they should interpret them in the context of political and regulatory structures of each nation. There are arguments to analyse jointly the political-institutional structure of a nation and preferences of the actors that inhabit them, with the level of political competition by consumers groups, competitors, suppliers of the companies or competitors. When level of political competition is considered, the regime can help to attenuate underinvestment problems (when political competition is harder), and overinvestment (when political competition is softer). The analysis can also be extended to incorporate other important characteristics of the institutional environment. This includes, but is not bounded, to



electoral and institutional rules and procedures to appoint judges, regulators and bureaucrats of higher range, as well as political procedures.

The “Political Risk Services' International Country Risk Guide” (ICRG), provides four measures that include Political Risk, Economic Risk and Financial Risk, and a Compound Risk that is function of the other. Initially, Erb, Harvey and Viskanta (1996), explored whether risk indexes contained information about prospective future returns. They found that it happens, and the measure of Financial Risk has the richest informative content. The measure of prospective future returns and of political risk, contained less information. They prepared a portfolio of countries that experienced a decrease in risk grades, and another portfolio with countries that had an improvement. The portfolio was armed after the information of risk was available, and re-balanced every six months. Then they analysed nexus between those country risk measures, and some more traditional risk measures, as the correlation among the beta value of a country against the world MSCI index. As an alternative, they investigated the relationship among the measure of country risk, and stocks volatility. Thus, they explored the relationship among country risk analysis and investment strategies based on fundamental information, like books/prices ratio. They found that risk indexes are highly correlated with fundamentals. They took measures of ten sources of risk<sup>2</sup>. In detail, Institutional Investor and that of ICRG methods are pointed out (Erb, Harvey and Viskanta, 1999).

Institutional Investor is based on a survey of international bankers' leaders that should elaborate a country ranking in a scale from 0 to 100 (worse to better). Institutional Investor averages the grades, weighting more answers of those interviewed with bigger international exhibition and more sophisticated analysis of risk country systems. It is hard to determine what elements interviewers have in mind to qualify: bankers elaborated ranges of different factors for different groups of countries, and the rankings changed along the time (Erb, Harvey and Viskanta, 1999).

ICRG compiles monthly data about a variety of political risk (13), financial (5), and economic (6) factors, to calculate compound index. Scores of the political factors are based on a subjective analysis of information. The compound qualification is a lineal combination of individual scores. To political risk measure, double weight is assigned to the financial and economic factors. ICRG conceived risk country as composed by two primary elements: ability to pay and willingness to pay. With the first factor are linked financial and economic measures, second is tied to the political measure. In emergent markets there is a positive relationship between political risk and volatility. Analysis suggests that considerable information is contained in the compound ICRG index, and in particular in its financial and economic grades. For example, when portfolios are formed with basis on changes in risk grades, they find supra-normal returns adjusted by risk of up to 1000 basis points per year. Carrying out the same exercise with the political risk measure, it doesn't yield abnormal returns. Risk measures of ICRG, in particular the financial one and the economic one, can predict expected returns in cross section analysis. As long as changes in political qualification have some marginal explanatory power in emergent markets of equity, but not in developed markets. They found that risk country qualifications are correlated with fundamentals of stock markets: 25% of the variance of books/prices ratio, in cross sectional data, can be explained by risk grades (Erb, Harvey and Viskanta, 1999).

---

<sup>2</sup> Bank of America World Information Services, Business Environment Risk Intelligence (BESI), Economist Intelligence Unit (EIU), Euromoney, Institutional Investor, Sand P Qualification Group, Political Risk Services's ICRG, Political Risk Services: Coplin-O'Leary Rating System and Moody's Investor Services.

## IV-International and another mechanisms

Following Moran (1999), mechanisms to diminish or to mitigate political and regulatory risk and can be classified in:

- 1) "Self-Aid" measures of regulatory reforms, in order to diminish the risk.
- 2) International treaties, international law and international arbitration to treat those conflicts and disputes that cannot be resolved appropriately in the local level.
- 3) Insurance, guarantees and other products to reallocate the risk, offered by third parties.

### IV-1 "Self-Aid"

Around the use of "Self-Aid" measures of regulatory reforms, host countries that developed procedures and subsequent reputations to try with investors in friendly form, *ceteris paribus* would enjoy bigger investments and of better quality. The first measure is the protection of property rights. It combines the prohibitions of arbitrary acts of dispossession, and "prompt and appropriate compensation" in the event of expropriation based on public utility reasons. Embedded property rights protection, there are reliable procedures to assure contract execution. Public transparency and an independent and reasonably efficient judiciary, supplement the above-mentioned. Sectoral regulations can be quite general or highly specific. Regulatory agencies represent a deliberate effort to limit political control about entrance decisions to the industry, return from investments, price of the product, standard of service and flexibility to changes in parameters, in answer to alterations in the external atmosphere. Regulators should be isolated of influences and liberated from conflicts of interest. Studies of the regulatory agencies in the United States, suggest that elected regulators are more prone to popular pressures in unfavourable form to investors, than designated regulators. A form to face pressures on government, to take control in the decisions, is to inject so much competition as is possible in the regulated industries (Moran, 1999).

The nature and reach of the political and regulatory risks, depend among other things, on the institutional atmosphere, and on the incentives the public agent face. Risk decrease by means of policy reforms, is a difficult task because it requires to establish credible commitments from governments, consumers and infrastructure suppliers. Credibility requires the creation of a system of incentives such as the public and private interests converge.

Modern economic analysis shows the importance of the institutional atmosphere in the understanding of the incentives of public agents. Economic development depends on the institutional environment reflected in formal rules of the game (constitutions, laws, regulations, contracts) and informal rules of game (values, customs, traditions). Institutional economy has constituted an integrated analytic approach (Jadresic and Sources, 1999) that:

- 1) Emphasises cultural and institutional factors.
- 2) Makes interdisciplinary analysis.
- 3) Does not require the assumption of rational profit-maximisation agents.

- 4) Uses comparative historical and empirical material intensively about socio-economic institutions.

Under this perspective, preferences are endogenous with respect to the institutional and social atmosphere. Actions of the agents and their interaction (that defines the economic acting), are determined by incentives, depending on institutional arrangements. The efficiency of the State, in the principal-agent model, not only depends on its internal organisation, but also of its interaction with the society as a whole. In turn, institutions are the endogenous result of several processes along the time (Jadresic and Fuentes, 1999).

There are two approaches for policies design, transparency and credibility that can change the incentives. In a world of imperfect information, actions of the agents are not observed by the principal. Transparency reduces that bias, when expanding the available information. In this context, transparency is a combination of information and control mechanisms that conditioned the interaction among the agents (regulated) and the principals (regulators), as well as a system of incentives. When one adds time dimension, they should also be considered that objectives of the governments can change along the time, that private decisions have an irreversible component, and that private agents learn from government's decisions. Then, credibility is an approach that allows to correct the incentives bias against the public interests, when allowing flexibility to diminish the opportunistic behaviour of the rulers. The action of the State to diminish political and regulatory risks in the infrastructure sector should take into account uncertainty and the informative shortcomings faced by the State.

The level of political and regulatory risks are related with four basic elements, and with them the measures to diminish the risk:

- 1) Structure of the markets.
- 2) Regulations.
- 3) Regulatory organisations.
- 4) Socio-political and regulatory atmospheres .

Competition in the markets can diminish risks for different reasons: the necessity of regulations falls, bounding the reach of the government's discretion, it decreases the possibility to the existent companies of adopting anticompetitive actions, and the absence of competition can generate unpredictable political decisions affecting the whole industry. To promote competition, certain basic principles could be followed. A careful privatisation is the first of them. In privatisations usually are two objectives in competition: to maximise the collection and to generate a competitive market structure.. In second place, to limit as much as possible, the vertical integration. Third is the validity of a culture of fair competition. The market structure and the ruling economic system, create informal rules of the game that conditioned the economic interaction among the agents (Jadresic and Sources, 1999).

To diminish the regulatory risks, an efficient regulatory performance is needed. It requires the creation and operation of incentives that can induce the economic agents and the own regulators to act in predictable form according to objectives. The formal rules of the game should satisfy clarity, stability and economic rationality. Clarity of the norms means that the reach for the interpretation of the rules should be as limited as it is possible. Stability could be generated with

different instruments, as constitutions, laws, ordinances, rules, contracts and international treaties.

A group of strategies could be implemented to improve credibility and transparency. The independence of regulators, leads to regulatory decisions that respond to social objectives and not to pressures of economic or political groups. Incentives to be a regulator and correct selection mechanisms are essential. Regarding the first point, the instruments are social prestige, remuneration's and a strict selection process. To assure the independence, could help:

- 1) Appointments for fixed periods that do not coincide with political cycles.
- 2) Constraints and specific conditions for regulators' removal.
- 3) Autonomy of regulators, with different norms that the rest of the government.
- 4) Budget coming from a charge to the users, not resting on the approval of Congress or of Government.

Around the responsibility of the regulators, is bigger the bigger the degree of independence, or the possibility of discretion of the regulator. A strategy, is to expand the quantity and quality of available information to the public, and to establish formal mechanisms to monitor regulatory activity. Also, formal controls of third bodies could be introduced. Internet and consultation mechanisms, as public audiences, are tools of information spread. Regulatory tasks requires to pay qualified personnel. A policy towards human resources, includes the personnel's selection, wages, training, promotion and removal.

On the basis that disputes will appear, to diminish risks a resolution mechanism should be settled. Its key attributes are fairness, and technical knowledge. The classic instrument is the judiciary, but it faces a series of difficulties in many countries:

- 1) Sometimes, judges do not have technical knowledge of regulation.
- 2) Courts do not have the resources to solve regulatory disputes on time, and
- 3) The judiciary is not totally independent of government or of the parties.

Different alternatives can be contemplated, as mediation mechanisms to solve specific questions, or courts specialised in regulatory issues, leaving Judiciary as a last instance.

Constitutions, looking for to diminish the political risk can settle down:

- 1) That the expropriation of the property can only happen with the due process of the laws, for a legitimate public utility, and the holder has to receive prompt and fair compensation.
- 2) That the exercise of the regulatory power should take place according to a legal process, and that is only acceptable for a legitimate public utility.
- 3) That an independent justice exists to interpret and to revise the constitutional validity of the legislation and the regulatory actions.
- 4) That the legal tradition admits as interpretation of the clause of property, to claim compensation for unfair or excessive exercises of the regulatory power.

Ingrained constitutional dispositions (that can only be replaced by procedures and special majorities), guaranteeing compensation for expropriation of the private property, could attenuate certain political risks (confiscation or nationalisation), and the regulatory risk of the investments

in infrastructure. The regulatory risk can be frequently bounded, through rights recognised in the contracts of investments, in administrative dispositions, through the international arbitration, or on the basis legislation. A law of compensation based on the notion of regulatory takings, provides an additional strategy, when giving an extra option. It provides a secure protection that these rights are rooted in the constitutional structure, so that they cannot be revoked easily through changes in the common legislative or administrative policy (Van Der Walt, 1999).

An independent justice with jurisdiction to interpret and to apply the constitution, and to say about the constitutional validity of the legislative and administrative actions, is an important factor to obtain compensations for losses caused by excessive or unfair regulation. In the absence of an independent justice, protection can be obtained through international or regional courts, and of compensation guarantees. However, the recognition of the notion of regulatory takings do not imply that some regulatory interference can or should be treated as such, and compensated. The regulatory actions serve to a legitimate public purpose, without imposing an excessive or unfair load, is not usually compensated.

The State can reduce the risks for the investors in infrastructure, by norms that limit its aptitude to tunnel the profitability of the projects settling down. Those norms can be explicit in each contract and to provide kind of a guarantee against certain types of actions of the State. A bottom norm in the constitution of some States is a "Clause of Taking" that requires that the State pays a compensation when it takes a property for public use. For example, in the Constitution of the United States, the Clause of Taking is applied to government excesses or expropriation of the physical property (Ackerman and Rossi, 1999).

In developing countries, a national legal system consolidated for the protection of the contracts yields benefits not only to international investors in the host country, but for all the economic actors. The key for the establishment of such a legal system, however, is to establish a balance between the protection of property rights and the maintenance of the political flexibility. Ackerman and Rossi (1999), suggest that the countries should be cautious when incorporate a too rigid group of rules in the constitutions, the individual contracts, or the investment treaties, specifically if they are developing state institutions.

## **IV-2 International treaties, international law, and international arbitration**

The use of international treaties, the international law and the international arbitration, operate for two roads: they provide substantial protection regarding political and regulatory risks, and they facilitate disputes solving between investors and host governments authorities. There are more than 1200 bilateral treaties of investments protection. Most of them were negotiated in the last decade. Most contains provisions on expropriation, conversion and transferring of foreign currencies, and general provisions against discriminatory treatment. The expropriations of international investors can only take place if they are made for reasons of public utility, and compensation is paid. Some authors add the "prompt, appropriate and effective" compensation. In many cases jurisdiction moves to courts of third countries. When an arbitration provision is invoked, the dispute moves of jurisdiction. Awarded a case, the instance comes from inducing the execution of the demand. In absence of an international commercial judiciary, the natural aspiration of the parts to achieve a neutral treatment in the resolution of the dispute related with

international contracts, required the use of several private mechanisms. They comprise the arbitration, that allows to reach to a final resolution of the disputes, by means of elected referees for the parts or for a third independent party. The United Nations and the World Bank have had a prominent role in this sense, with the Convention of New York (1958), and the Convention of Washington (1965), that have had in each case more than 120 associated countries. Also, an important number of countries had adopted the Model Law of 1985 on International Commercial Arbitration, of the Commission of International Law of the United Nations (UNCITRAL), to increase the effectiveness of the processes in its corresponding jurisdictions. Also, the International Chamber of Commerce (ICC), that take charge of improving the international arbitration's (Schwartz and Paulson, 1999). The Convention of New York on the Recognition and Setting in Practice of Shortcomings of International Arbitration, with 100 countries members, is in charge of those questions in that referred to arrangements of commercial disputes among private parts. The ICSID do the same thing between foreign investors and governments. It is based on the consent of the parts that is considered irrevocable and has the exclusive mechanism of arbitration. Awards are mandatory on the parts, and they have the same force that a definitive trial in the country of the contracting State. The arbitration of the ICSID makes in fact, a court of appeals on national courts (Moran, 1999). International arbitration has as advantages that the dispute is solved by a third party, and the processes take place in third countries. Experts that understand the technical details of the dispute attend the audiences. The process could maintain confidentiality on commercial issues, and preserve the relationships among the parts. As disadvantages, the arbitration could determine who pays, but it does not have form of supervising the execution. It is also less useful when the local regulators have discretion in rules interpretation, or in the consideration of policy objectives. The discretion and reservation with which they are carried out the processes, had been pointed as attentive against the opening and transparency (Moran, 1999). The ICSID was created in 1965. From its foundation up to 1987, there were conducted 23 cases through ICSID (14 from 1981). Before being addressed a dispute, it should complete certain prerequisites: the agreement that solves the dispute cannot only be edited by one of the parts, the dispute should be legal and not commercial. "Investment" is not defined as a concept, and loans and industrial property are included in the investment notion. Lastly, the contracting states should recognise and fulfil completely the pecuniary obligations that arise from the awards.

Bilateral treaties of investment protection are a form of reducing the perception of political risk. Most has been subscribed between a developed country and a developing one. The treaties cover several matters of interest for the investors: the investors' treatment in the host country, expropriation, compensation and transfer of funds, resolution of disputes. The typical treaty contains the following elements:

- 1) Definitions: covered investments, covered geographical areas.
- 2) General declarations related to the promotion and protection of the investments.
- 3) A fair and equal investor's treatment, and due treatment of the most favoured nation.
- 4) Expropriation: for public interest, for a public purpose.
- 5) Compensation: perhaps the clause of prompt, appropriate and effective, and approaches to determine it.
- 6) Transferring of funds.

- 7) Exceptions.
- 8) Resolution of disputes between investor and host country.
- 9) Resolution of disputes between host country and origin country.
- 10) Assumption for the governments of the rights of the investors, if a compensation payment is needed (Kamga Wafo, 1998).

The obligations of the governments of paying compensations are reasonably well settled down in the international law in practice, and coded in treaties (bilateral, regional and multilateral). Bilateral treaties of investment have been used since the first one signed by Germany in 1959. Waelde (1999), suggest that there is not evidence that in fact they diminish importantly the political risks, or increase the levels of investments. In reality, it seems that countries that have not signed them, as Brazil and Nigeria, have attracted so much or more investments that those that signed them. For Waelde (1999), treaties have limited effect and they should be seen in perspective. A treaty plays a signalling role. Their signature generates a legal obligation, and it denotes some degree of domestic consent on the investments. The country accepts a level of international discipline and the implicit sanctions for not respecting it (bad publicity, possibility to lose an international arbitration). There is not evidence that the qualification of political risk is modified by the signature of treaties of investment protection. The companies do not seem to give them great importance. The treaties contemplate the traditional risks (expropriation), but not the modern risks of investment in infrastructure, regulation, ineffectivity of the legal system, low value of contractual commitments, effective competition policies and autonomous performance of subnational governments (Waelde, 1999).

Bilateral treaties offer protection to investments, by opening the possibility of international arbitration, but the sentences of this origin don't have practical form of forcing their execution. The effectiveness of the protection, depends on the clarity, specificity and applicability of the rules and standards of investment treatment contained in the treaties. Multilateral treaties of investment protection are much more ambitious and they start up with the miscarried Letter of Havana of 1947, whose commercial chapter constituted the GATT. The discussion of a Multilateral Agreement of Investments that will be signed by the countries of the OECD, was interrupted with the retirement of France in 1998. The criticisms that can be made are similar to those received by the GATT-OMC system (Waelde, 1999).

Arbitration of an investment dispute in infrastructure can be at the same time long and expensive. For it and for commercial or political considerations, parties generally arrive to a negotiated solution. There is a great variety of alternative procedures to facilitate the reconciliation and mediation. In many aspects, arbitration of disputes related with topics regulatory or political, is based on topics common to other arbitration cases. In each case, the consent of the parties is required, and the procedures to continue, generally derive from rules of wide application, as those of the UNCITRAL.

When the State is involved in the process, additional considerations could arise, possibly of legal nature (like questions of immunity or responsibility), or of political character, given by the public interest of the topic and the attitudes of the involved authorities. This means that the existent mechanisms of international arbitration could be effective in the reduction of political and regulatory risks, only if the parts grant full consent on their use. Also, the result of the arbitration should be respected. Beyond the arbitration clause in the contracts, is important that good

referees exist. Finally, although the parties generally want to minimise the costs associated to the procedure, they should be prepared to be presented in the more effective way before the arbitration, and that demands resources. The cost of the international procedures of arbitration, generally constitutes a barrier for developing countries.

The effectiveness of some international arbitrations, depend ultimately on the application of concessions that are understood as the conclusion of the process.

There are certain characteristics of the disputes of international arbitration that deserve to be outstanding. It is in discussion, given the public character of the disputes relative to government action or regulation, if the arbitration should be treated as a confidential process. Although the confidentiality is a characteristic of the arbitration that has increased its popularity, there are different opinions on its quality to solve differences that affect public interest.

The investors look for special protection, for investments in infrastructure in the form of host governments legal and contractual commitments from whom the stability in the time is not always guaranteed. International laws yield protection especially through Bilateral Treaties of Investments that are at the moment in validity among developing countries, transition economies and industrialised nations. Regional and sectoral integration agreements (such as GATS and the Treaty of Energy of Europe), also include provisions for investment protection.

According to the long term relationship among the parties in infrastructure projects, they should be imagined careful adaptations and re-negotiation clauses, to try with unexpected changes of circumstances and difficulty instances. The arbitration or the mediation should be foreseen if the parts could not reach an agreement in these situations (Sacerdoti, 1999).

### **IV-3 Insurance, guarantees and other products to reallocate the risk**

Insurances, guarantees and other products have been designed to treat with the risk. The necessity of insurance against political risks had origin in the modern history. The first shock for the stability of the international regime of private foreigner investment was the Russian revolution of 1917, with the nationalisation of foreign and domestic investments. In the first part of the 1920s, programs were developed to reduce the risks of foreign investments and trade, providing specialised ways of insurance of political risk, just as sure of commercial credit and guarantees of foreign investments. Private insurance companies spread its activities at the beginning of the 1970s. By the middle of the 1980s, there were more loans for investors in developing countries, on the basis of guarantees from local banks. Another answer to the Debt Crisis was the establishment of the Multilateral Investment Guarantees Agency (MIGA) in 1988, for members of the World Bank. The objective of MIGA was to encourage FDI in developing countries, providing insurance against political risks for private foreign investors, and technical assistance for governments (Bubnova, 1999).

In post-war years, governments acted to mitigate the coverage necessity that was not offered by the private insurers. United States established the Overseas Private Investment Corporation (OPIC), in 1971, in order to cover political risk, in Cold War context.

There are risks whose covering are too expensive for private suppliers, as wars and civil disturbances, and other political risks considered too much unpredictable for extension and



duration to value them actuarially and to appreciate them. From the second half of the 1990s, the private political risk insurance activity has expanded, and the time horizon of its products has expanded to 5 years for contractual ruptures, and 10 years for confiscations. The size of the contracts grew six times in the second half of the 1990s. Their providers were private institutions and multilateral organisms. Among these, the MIGA has built the biggest portfolio of guarantees against political risks. MIGA provides insurance to investors in member countries, with their consent. Still with low coverage, the influence of MIGA could be important. It could act as mediator among parties, helping to solve disputes before they escalate, and sometimes before they become public.

MIGA is basically an insurance company of FDI against political risks in developing countries. It has two main functions: to provide guarantees against non-commercial risks and to improve investment conditions and their promotion in developing countries. The guarantees program covers four types of non-commercial risk:

- 1) Constraints to foreign currencies convertibility.
- 2) Expropriation including "Creeping Expropriation" (governments' actions that indeed deprive the foreign investors of property or control).
- 3) Contract ruptures when the investor does not have access to, or time for a judicial audience or arbitration.
- 4) Armed conflict or civil disturbance.

MIGA provides attendance to host countries to attract FDI, of investigation, dissemination of information has more than enough opportunities and investment climate, technical attendance and advice.

Partial guarantees against risks of the World Bank, assure the payment in the event of non-fulfilment of debt service, of sovereign obligations, projects of the private sector, and the occurrence of certain events of major force in the host country. The partial guarantees of credit of the World Bank, are programs that have been designed to cover all the events of default, in one period, in the financing of a project, especially those of late maturation.

The creation of financial derivatives to cover against catastrophic risks, as hurricanes and earthquakes, can be a road to allow investors to cover along the life cycle of long term projects in multiple countries. The absence of an appropriate actuarial basis to calculate sinister likelihood, has not been an obstacle for the creation of markets of coverage of oil perforation in the North Sea, or launching commercial satellites, before statistics existed to place a basis. What is required is a price for the risk. On the other hand, the covering presence creates a problem of moral hazard: incentives of the member country appear acting opportunistically, when they know the investor is covered (Kamga Wafo, 1998).

The idea of constituting international disciplines for investment protection, has been faced by many roads, mainly for the World Bank and the OECD. The first includes all the measures that look for investments policies of the host countries. The second is the creation and starting of a new multilateral insurance agency for political risks. The third form is the creation of an organisation for arbitration and investment disputes. In fourth place, extension of OMC rules towards investments. These rules include transparency of investment rules, the application of the concept of more favoured nation, and national treatment of investments (Kamga Wafo, 1998).

Several mechanisms exist (in operation or proposed) at multilateral level, to diminish concerns over security of investments and political risk. The most important initiative has been Multilateral Agreement On Investment (MAI), negotiated in the OECD. It would be in charge of a group of topics, each one reflecting the obstacles faced by investors in foreign markets. The first one is basic access to the market and fair treatment to settle down in a particular jurisdiction. Participants would be given national treatment to each other in investments, and the agreement would be mandatory, containing effective provisions for dispute resolution.

United States has a quasi-governmental organisation (OPIC, "Overseas Private Investment Corporation") that assures to the American investors against losses for expropriation, currency inconvertibility, war, riots and insurrections, loading a premium. In Japan, a similar service is provided by the Ministry of External Trade and Industry (MITI), in Germany for Treuarbeit, in the United Kingdom for Export Credits Guarantee Department (ECGD), and in Canada for the Export Development Corporation (Kamga Wafo, 1998).

The sector of private insurance industry was born by the middle of the 1970s. The pioneers were the American International Group (AIG), and the Lloyd's of London. There were many small interactions among the public agencies and the private insurers in that time. In the 1970s and 1980s, the infrastructure finance took the form of big loans syndicated to sovereign governments, or offers of medium term credits. With the Debt Crisis, the reinsurance did not work. The insurers, lost the appetite for these kind of business, and were retracted to their old competences. But, some few ones persevered and survived. During this process credibility was restored with the reinsurers, and the relationship with agents and clients was kept. Today the private sector has replaced the government like primary supplier of covering in most of western countries (Salinger, 1999).

In the exit of the Debt Crisis, governments diminished the loans taking. Privatisation's came, and with them, the development of energy, telecommunications and transport projects, requiring big amounts and capacity of risk absorption. This capacity came fundamentally from export credit agencies, multilateral entities, capital markets, commercial banks, as well as of the private and state insurers. Due to the appearance of these investment opportunities, the coverage against political risks were convenient for projects and privatisations. The private sector considered good the occasion to invest. The coverage is available nowadays for more than twenty years. Longer coverage terms include inconvertibility of the foreign currency, as well as confiscatory risk. Now it is also available the covering against wars, some of these on the basis of medium and long terms contracts (Salinger, 1999).

Offers of private sector products, are virtually identical today to the available ones from public agencies. In the future, the first question to keep in mind, is if the public agencies exist to compete or to complement the private sector. If governments hope its agencies complement the private sector, they need to compare the costs of provision of the service with the one of privatising them, but here a difficulty is presented: financial results are not comparable. A complete evaluation should make appropriate adjustments to differ among the two sectors, contemplating such things as its tax status. Most of the public agencies proclaim that their mission is to supplement and not to compete with the private sector (Salinger, 1999).

If the public agencies decide that their mission is to supplement, or not to compete with the private sector, they shall decide as making it. There are three options:

- 1) To be the insurer of reference and to absorb risks syndicated for the private sector buying reinsurance.
- 2) To support to the private sector in selling reinsurance to qualified insurers, or
- 3) To work next to the private insurers to share the risk like a co-insurer.

The private sector is finding the necessary market to provide more insurance of short term export credit. In medium and long term export credit, including the related to insurance, public agencies prevail. However, the increase of capacity in insurance of private investment of long term, suggests that the private sector could make more. The investment insurance experienced changes in the last years. Coverings were developed on privatisation and financing of infrastructure projects. The capacity of the private sector expanded significantly in reach, number and depth. Today the sector can provide covering above US\$ 1 billion against confiscation risk, expropriation, nationalisation and inconvertibility on foreign currencies. The third traditional covering investment of insurance, political violence, was not available in the private sector until the beginning of the programs of expansion of AIG's in 1996, registering today available capacity. Where private sector and public agencies can be supplemented is in investment insurance. A positive step in this address was the recent announcement that the World Bank was combining its resources with Lloyd's of London to support new investments in Bosnia after the war.

Bubnova (1999) makes an inventory and analysis of the different insurances against political risks and guarantees, provided at the moment by both, private and public sector. Its scope is the protection of investments, patrimony and debts against specific political risks, so much as the guarantees can take several forms: guarantees against partial risks, guarantees of partial credit, guarantees with total covering (against all risk).

Insurance's and guarantees against contemporary political risks, cover a wide spectrum of risks:

- 1) Almost all the plans of insurance cover confiscation, expropriation and nationalisation (clause CEN in the contracts), acts happened in the political period that deprives all or it leaves of the shareholders in foreign companies and/or their average assets. Other similar risks, is deprivation (added to CEN, forms the clause CEND), and the abandonment for the force of investments or the asset.
- 2) Risks of convertibility and transferability of investment dividends.
- 3) Losses due to events of political violence, including wars, terrorism, sabotages, civil shocks, etcetera.
- 4) Not standardised risks, of contract repudiation by host countries.

Public suppliers of insurance against political risks include multilateral banks, export credit agencies, bilateral and multilateral organisations and corporations that promote private investment. The World Bank, the European Bank of Reconstruction and Development, the Inter-American Development Bank, and the Asia Development Bank, are property of the own governments members. The mitigation of political risk takes the form of guarantees, of partial risk, or of partial credit. These programs cover risks associated with the governments' contractual obligations that include a wide range of sovereign risks. There are other suppliers of insurance against political risk. These include the Islamic Development Bank that has as subsidiary the Islamic Corporation for Investment Insurance and Export Credit. It covers investments among

member countries. The Inter-Arab Corporation of Investment Guarantees, covers investments among the 21 countries of the Arab League.

Agencies of Export Credit, are organisations of each government. Their objective is to promote exports (and in some cases investments), in accordance with economic policy objectives. They are examples, COFACE for France, ECGD for the United Kingdom, EDC for Canada, MITI for Japan and the SACE for Italy. In most of the countries the national export credit agencies offer credits to the export and investment insurance.

Insurers of the private sector have commercial objectives and of profit maximisation. They are not restricted by requirements of investors' nationality, or for considerations of national policies. However, they are subject to constraints of national or international sanctions (they do not assure investments in Cuba, Iran, Iraq, Libya or North Korea). Nowadays, insurance against deprivation risk is contained primarily in the United Kingdom, the United States, and Bermuda. They can assure debt and patrimony, projects already existent or new, and they don't have limitations on the acceptable investment. Private insurers are not tied by rigid eligibility approaches. They are flexible in coverage terms of new projects, and they are not limited to certain geographical regions (their clients can assure globally). Private transactions are absolutely confidential. They can cover up to 100% of an investment. The limitations of most of the insurers of the private sector include a lower capacity and covering terms that those offered by the public sector. However, in the last years, private capacity was largely increased, and combining sources in the private markets, a client can exceed the amount offered by a public sector insurer.

In the discussion on private versus public insurance provision, intervene some considerations on behaviour incentives. Some academics use information theory to support public intervention in the private market. Among the advantages that governments have over the private sector are economies of scale and scope, screening, enforcement of contracts, effectiveness for socialise losses, and monopoly of the public force. However, there are also positions against the intervention of the governments in the political risk insurance market. Klein quoted by Bubnova (1999), asserts that when the governments take the role of insurance suppliers, taxpayers become captive investors of a long term fund.

Private insurers have certain advantages of efficiency over the government. For example, insurance companies are in a better position that the sovereign governments to diversify their portfolios. Privates are also under better conditions to adapt their prices and to evaluate in a better way the risks. In the case of public insurance, these can take not foreseen fiscal obligations, destabilising the macroeconomic situation of some countries. Problems of asymmetric information happen in both systems, publics and private. Moral hazard and adverse selection can affect the costs of the insurance business, and the influence of the private ones versus publics in market composition.

In private insurance they cover specific contracts or interests. The "interests" assured, are the costs of providing or manufacturing the goods, providing the services or paying purchases. The main covered political risks, are seizures of exports and imports, the risk of not being paid (if the buyer is a state agency), inconvertibility and inability of transferring foreign currencies. In investments, the investor insures shares or assets possessed in a local company (or the loans made regarding this company). They insure against confiscation, political violence and constraints to profit remittances. The capacity to cover contracts has arrived to U\$S 600 millions, and the capacity of covering interests to U\$S 1750 millions. Periods of coverage have extended up to ten

years or more. Coverage have extended to the case of war, to exception of those that took place among the five bigger military powers (United States, Russia, China, United Kingdom and France), and the use of nuclear weapons. It do not exist in the world more than 10 syndicates or insurance companies as Lloyd's or AIG with the capacity to insure infrastructure projects, as well as to subscribe an important portion of the risk. About seven syndicates in Lloyd's could subscribe each one US\$ 50 millions or more with regard to a single investment project (Alington, 1999).

The business that Lloyd's covers in political risk, are traditional investment protection, risk of war over fixed assets, aircrafts and ships, and contractual risks and contingents for investment and trade. Lloyd's is not a company but a market, where syndicated subscribers, taking risk on its individual capitals, compete for business through credited brokers (Lloyd's Brokers). The capital used by each syndicates has been for about 300 years contributed exclusively by rich individuals ("Names"). Since 1994, the market has admitted members with limited responsibility. The capital of companies is now 60% of the market, against 40% of "names" participation. The size or capacity of the syndicates is not measured in absolute terms, but in its ability to accept premiums. In 1998, the capacity of the market was of US\$ 16 billion. Lloyd's has a chain of security. The first defence line is the fiduciary funds: policies are paid from there. Then come funds that the members of Lloyd's should maintain according to formula. Members respond until the entirety of their assets. A central basis of Lloyd's is available to cover any commitment surplus. The basis of total capital was in 1998 in some US\$ 251 billion. From recent date, movements exist to incorporate external ratings to show the strength of the capital basis of Lloyd's. There has been a consolidation process of syndicates, from 450 separated entities in 1990, to 150 in 1999. The average size of the syndicates has grown to some US\$ 105 million accepted premium. In each specialised type of insurance there is a small number of specialist leaders subscribers. The leader will negotiate terms and coverage conditions, he will determine the risk, indicating a "line", or an amount that he wants to subscribe. Agreed the terms, the broker has to obtain support of those willing to participate in the conventional terms (James, 1999). In political risk, there is around a dozen of unions that are leaders, and a thirty minor that follow them. The first ones can commit US\$100 million or more to a single risk, as long as the later around US\$ 5 million. At the moment, the combined capacity of Lloyd's is of some US\$ 800 million for confiscation, US\$ 450 million for war or political violence, and US\$ 350 million for currencies inconvertibility. The periods cover five years or more, and in occasions they can arrive to ten years. Private market provides coverage against catastrophic political losses. They cover main confiscation dangers, war, terrorism, and exchange controls. Historically, investment insurance was limited to the main previous risks. At the moment, they are covering transactions and seeing how to apply to the investment risks, considering seizure, cancellation of licenses, unfavourable shortcomings by arbitration and not execution of guarantees (James, 1999).

In recent years, capital markets have been used as alternative or supplement of the insurance market risk transferring. The biggest use has been in the area of catastrophic losses in properties (results of earthquakes, hurricanes and in engine insurances). In political risk they have been used in limited form in three forms: financial derivatives, contingent shares and fund emissions. Those derived for sovereign nonfulfilment allow exporters or suppliers the option of selling at a third party the debt that has the public sector with them. The option is exercised if there is nonfulfilment, being the third party (buyer) in charge of recovering the debt. Such derivatives are applied mainly to export contracts with public buyers, being less appropriate for contracts of

infrastructure projects. It lacks a market for index (or indexes) of political risk to be trade). The use of indexes has allowed the development for coverage markets of natural disasters. There are factors like exchange rate and interest rates that can be used as indicators, but these do not have a direct correlation with the type of political risks that can impact in an infrastructure project. Risk ratings can be used, but these they are bound to the capacity to serve foreign debts that to the expropriation risk or war (Alington, 1999).

## V- Concluding Remarks

The present work had as its objectives to characterise the problems of political risk and regulatory risk theoretically, to study the existent measures of political risk and regulatory risk, and to show the available instruments to face them. Lastly, it looks for to extract conclusions of general nature on political and regulatory risk, and of particular character, referred to the infrastructure concessions, presented here. The paper is limited to study political and regulatory risk, when the causing one is the government: opportunistic behaviour of the companies is not analysed.

To characterise the political risk and the regulatory risk, and their influence in the infrastructure concessions, a form is to treat the problem is as one of opportunism, in the frame of the well-known "economy of the transaction cost."

The political and regulatory risks can be defined as shocks to the profitability of projects that derive of some government action or inaction, before changes in market conditions. They are also different from acts of the nature, accidents and crimes.

Infrastructure projects are particularly sensitive government action or inaction. They are usually regulated monopolies. They accustom to be considered essential services and they are very exposed to public scrutiny and public attacks. They use important sunk resources with long repayment periods. In some cases there are state dependencies that are their suppliers or key clients. When there is FDI, the exchange conversion necessity or remittances of foreign currencies exist, and governments can control them. Thus, opportunism could appear. The infrastructure projects can suffer political, social, environmental protests, and opportunism of the regulator.

Political and regulatory risks can be divided in three superimposed categories: traditional political risks (acts of opportunism), regulatory risks (that arise of the application and execution of regulatory decisions or of its absence) and nonfulfilment risks for the government or state entities, of procurement agreements.

The definition of political risk can be extensive or restrictive. The extensive definition includes acts of all species, without caring where they were originated. From this perspective, the sources of political risk are the governments, and also social uncertainty.

In the specific case of the public services of infrastructure, the conditions of the problem make them permeable to the political risk, as a result of opportunistic behaviour in a context of limited rationality, possible in transactions where there is high specificity of the assets (a sunk net), contracting frequency for extensive periods, with periodic revisions of the administration and possibility of initial condition renegotiations, all the above-mentioned in presence of uncertainty.

On the behaviour, the economy of the transaction cost supposes that can exist bounded rationality and opportunism. Bounded rationality supposes that the agents are intentionally rational only in a limited form. Bounded rationality in the economy can affect decision processes, and government structures. For "opportunism" it is understood the search of self interest with deceit. It includes lie, robbery and deceit, negligence or deliberate omission; forms so much active as passive, and the types *ex ante* and *ex post*. In general, opportunism refers to incomplete or distorted revelation of the information, especially premeditated efforts to mistake, to distort, to hide, to confuse.

The main attributes of the transactions, important for the present discussion, are: asset specificity, uncertainty and frequency. For contractual theory, the presence of bounded rationality and opportunism implies that wide contracting is limited, and the contract understood as promise is a frank focus. The consequences for economic organisation are that the exchange will be facilitated when the transactions will create in a sequence and with adaptive decisions, and spontaneous safeguards or contingents rules are generated.

There are numerous approaches to determine political risk, including decision trees, technical actuarial or statistical decision theory. In most of the cases, a mixture of subjective and objective approaches are used to analyse and to determine the political climate of a country. The subjective classic approaches include three methods: Grand Tours, Old Hands and Delphi, and among the objective ones, highlights multivariate econometric techniques. In more recent years, indicators of political risk have been developed. One of the most used general indexes, is the Business Risk Service Index. Another systematic indicator of political risk is the one that World Political Risk Forecasts. Other measures are those from Frost and Sullivan, International Country Risk Guide, and those of Institutional Investor. As drawbacks they extrapolate last actings to estimate future results, and isolated events can have a strong impact on the operations and benefits of the companies. There are partial political indicators as Corruption Perceptions Index of Transparency International. The Political Risk Services' International Country Risk Guide, provides four measures that include Political Risk, Economic Risk and Financial Risk, and a Compound Risk that it is function of the former. They contain information about prospective future returns, especially, in the measure of Financial Risk. Institutional Investor is based on a survey of leader international bankers that have to elaborate a range of countries in a scale from 0 to 100 (worse to better). The ICRG compiles data monthly about a political, financial, and economic variety of risk factors, to calculate compound index. The scores of the political factors are based on a subjective analysis of information. The compound qualification is a lineal combination of the three individual scores. To the measure of political risk a double weight is assigned to the financial and economic factors.

Host countries that develop procedures and subsequent reputations to try with investors in a friendly manner, *ceteris paribus* would enjoy bigger investments and of better quality. The first policy is the protection of property rights. It combines the prohibitions of arbitrary acts of dispossession and insurance of “prompt and appropriate compensation“ in the case of expropriation based on reasons of public utility. Embedded to the protection of the rights of property, there are the reliable procedures to assure contract execution. Public transparency and an independent and reasonably efficient judiciary, supplement the above-mentioned. A form to face pressures on government to intervene in the decisions, is to inject so much competition as it is possible in regulated industries.

The modern economic analysis shows the importance of the institutional atmosphere in the understanding of public agents incentives. Economic development depends on the institutional environment reflected in formal and informal rules of the game. There are two criteria for polity design, transparency and credibility that can change the system of incentives. In a world of imperfect information, “agents” actions are not observed by the “principals”. Transparency reduces that bias, when expanding available information. In this context, transparency is a combination of information and control mechanisms. Credibility is an approach that allows to correct the incentive bias against public interests, when allowing flexibility to diminish opportunistic behaviour of governments. Competition in the markets can diminish risks for



different reasons: regulation necessity falls and with it the reach of the government discretion. Also, the possibility to the existent companies of adopting anticompetitive actions decreases. The absence of competition can generate unpredictable political decisions that affect the whole industry.

To diminish regulatory risks it is necessary an efficient regulatory performance. It requires the creation and operation of a system of incentives that can induce economic agents and regulators to act in a predictable form according to objectives. The formal rules of the game, should satisfy clarity, stability and economic rationality. Clarity of the norms means that the reach for the interpretation of the rules has to be as limited as possible. Stability can be generated with different instruments, as constitutions, laws, ordinances, rules, contracts and international treaties.

On the basis that disputes will appear, to diminish risks a resolution mechanism should settle down, whose key attributes are fairness, technical knowledge and celerity. The classic instrument is the judiciary, but it faces a series of difficulties in many countries. It can be contemplated other alternatives, as mediation mechanisms, leaving to the Judiciary as last instance. In some legal traditions, there are open and peculiar claims of compensation for regulatory takens.

Use of international treaties, international law and international arbitration, operate by two ways: they provide protection against political and regulatory risks, and they facilitate the settlement of disputes between investors and host governments authorities. There exist more than 1200 bilateral treaties of investment protection, most of them negotiated in the last decade. Most contain provisions on expropriation, conversion and foreign currencies transferring, and general provisions against discriminatory treatment. In many cases they are moved to the jurisdiction of third countries courts. When an arbitration provision is invoked, then the dispute moves of jurisdiction. The Convention of New York, with 100 countries members, is in charge of those questions referred to arrangements of commercial disputes among private parts. The ICSID do the same between foreign investors and governments. It is based on consent of the parties. It is considered irrevocable and has the mechanism of the arbitration, exclusively. Awards are mandatory, and they have the same strength that a definitive trial in the country of the contracting State. The arbitration of ICSID works in fact as a court of appeals on national courts.

Bilateral treaties of protection are a form of reducing political risk perceptions. Most has been subscribed between a developed country and a developing. Treaties cover several matters of interest for the investors: treatment in the host country, expropriation, compensation and transfer of funds, disputes resolution. A treaty plays a signalling paper. Its signature generates a legal obligation and denotes some degree of domestic consent on the investments. The country accepts a level of international discipline and the implicit sanctions for not respecting it.

The effectiveness of some international arbitration, depends in last instance on the application of concessions that are understood as the conclusion of the process. It is in discussion, given the public character of the relative disputes to the government action or regulatory, if the arbitration should be treated as a confidential process.

Insurances, guarantees and other products have been designed to deal with political risk. Another answer to the Debt Crisis, was the establishment of the Multilateral Agency of Guarantees for Investments (MIGA) for country members of the World Bank in 1988. The objective of MIGA went to encourage FDI in developing countries, providing insurance against political risks for

private foreign investors, and technical attendance for the governments. In post-war years, the governments answered to mitigate the covering necessity that was not offered by private insurers. United States established the Overseas Private Investment Corporation (OPIC), in 1971, in order to helping in the covering of the political risk, in the context of the Cold War.

There are risks whose coverage is too expensive for private suppliers, as wars and civil disturbances, and other political risks considered too much unpredictable as for extension and duration like to examine them with actuarial criteria, and to price them. Since the second half of the 1990s, the private activity of political risks insurance sector has expanded, and the time horizon of its products has expanded to 5 years for contractual ruptures, and 10 years for confiscation.

Sector of the private political risk insurance companies was born by the middle of the 1970s. The pioneers were the American International Group (AIG), and the Lloyd's of London. The offers of products of the private sector are virtually identical today to the available ones from public agencies. The capacity of the private sector expanded significantly in scope, number and depth. Today the sector can provide covering above US\$ 1 billion against confiscation risk, expropriation, nationalisation and foreign currency inconvertibility.

The insurance and guarantees against contemporary political risks, cover a wide spectrum of risks: almost all the insurance plans cover confiscation, expropriation and nationalisation, convertibility risks and dividend transferability, losses due to events of political violence, including wars, terrorism, sabotages, civil riots, etcetera, and not standardised risks, of contracts repudiation for the host countries.

Private insurance cover specific contracts or "interests". Assured "interests" are the costs of providing or manufacturing the goods, providing the services or paying the purchases. The main political risks covered, are exports and imports, debt defaulting (if the buyer is a state agency), inconvertibility and inability of foreign currencies transferring. In investments, shares, or assets possessed by the investor in a local company (or the loans made regarding this company) are assured. There are insurances against confiscation, political violence and constraints to profit remittances. The capacity to cover contracts has reached to US\$ 600 million, and the capacity of covering interests to US\$ 1750 million. The periods of coverage have extended up to ten years or more. Coverages have extended to the case of war, with exception of those that took place among the five bigger military powers (United States, Russia, China, United Kingdom and France), and the use of nuclear weapons. They do not exist in the world more than 10 conglomerate or companies of insurance to the style of Lloyd's or AIG with the capacity to cover infrastructure projects, as well as to subscribe an important portion of the risk.

In recent years, capital markets have been used as alternative for supplementing insurance to transfer risk. The biggest has been in the area of catastrophic losses in properties. In political risk they have been used in a limited form in three ways: financial derivatives, contingent stock and fund emissions.

## References

Alexander, Ian, Colin Mayer and Helen Weeds (1996). Regulatory Structure and Risk in Infrastructure Firms. An International Comparison. Policy Research Working Paper 1698. Washington, December: The World Bank.

Alington, Nigel (1999). Recent Development in you Deprive yourself Markets for Political Risk Insurance. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Bubnova, Nina (1999). Guarantees and Insurance for Re-Allocating and Mitigating Political and Regulatory Risks in Infrastructures Investment: Market Analysis. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Burns, Phil and Antonio Estache (1999). Information, Accounting and the Regulation of Concessions Infrastructures Monopolies. Policy Research Working Paper 2034. Washington, December: The World Bank.

Crampes, Claude and Antonio Estache (1997). Regulatory Trade-Offs in the Design of Concession Contracts. Policy Research Working Paper 1854. Washington, November: The World Bank.

Erb, Claude, Campbell Harvey and Tadas Viskanta (1996). Political Risk, Economic Risk and Financial Risk. Earlier Draft of an Article Published in November/December 1996 Financial Analysts Journal.

Guasch, Luis (2000). Lessons From Ten Years of Experience in Concessions. The World Bank, March, Mimeo.

Guasch, J. Luis and Robert Hahn (1997). The Costs and Benefits of Regulation: Some Implications for Developing Countries. Policy Research Working Paper 1773. Washington, June: The World Bank.

Henisz, Witold and Bennet Zelner (1999). Political Risk and Infrastructure Investment. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Herring, Richard (Editor) (1986). *Managing International Risk*. Cambridge University Press.

Jadresic, Alejandro and Fernando Fuentes (1999). *Government Strategies to Reduce Political and Regulatory Risks in the Infrastructure Sector*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

James, David (1999). *Political Risk Insurance in the Private Market*. Seminar: Private Infrastructure Development: Confronting Political and Regulatory Risks. September. Rome.

Kamga Wafo, Guy (1998). *Political Risk and Foreign Direct Investment*. Faculty of Economics and Statistic. University of Konstanz.

Klein, Michael (1998). *Bidding for Concessions*. Policy Research Working Paper 1957. Washington, August: The World Bank.

Macho-Stadler, Inés and J. David Pérez-Castrillo (1997). *An Introduction to the Economics of Information. Incentives and Contracts*. Oxford University Press.

Moran, Theodore (1999). *Political Regulatory Risk in Infraestructura Investment in Developing Countries: Introduction and Overview*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September, Rome.

Newbery, David (2000). *Privatization, Restructuring, and Regulation of Network Utilities*. The Walras-Pareto Lectures at the Ecole des Hautes Etudes Commerciales. Université de Lausanne.

Perotti, Enrico and Pieter van Oijen (1999). *Privatization and Political Risk in Emerging Economies: Evidence and Implications for Emerging Stock Market Development*.

Rose-Ackerman, Susan and Jim Rossi (1999). *Takings Law and Infrastructure Investment: Certainty, Flexibility and Compensation*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Sacerdoti, Giorgio (1999). *The Sources and Evolution of International Legal Protection for Infrastructure Investment Confronting Political and Regulatory Risks*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Salanie, Bernard (1997). *The Economics of Contracts. A Primer*. The MIT Press. Cambridge MA, London, England.

Salinger, John (1999). *Guarantees and Insurance: Future Directions for Public Agencies*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Schwartz, Eric and Jan Paulsson (1999). *Confronting Political and regulatory Risks Associated with Private Investments in Infrastructure in Developing Countries: The Role of International Dispute Settlement Mechanisms*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Van Der Walt, A. (1999). *Reducing Regulatory Risk in Infrastructure by Requiring Compensation for Regulatory Takings: A Comparative Perspective*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Waelde, Thomas (1999). *International Treaties and Regulatory Risk: The Effectiveness of International Law Disciplines, Rules and Treaties in Reducing the Political and Regulatory Risk for Private Infrastructure Investment in Developing Countries*. Seminar: Private Infrastructure for Development: Confronting Political and Regulatory Risks. September. Rome.

Williamson, Oliver (1985). *The Economic Institutions of Capitalism*. The Free Press, New York.

# CEER Working Paper Series

To order any of these papers, or all of these, see instructions at the end of the list. A complete list of CEER Working Papers is displayed here and in our web site

WPS 1. Laffont, Jean Jacques: Translating Principles Into Practice in Regulation Theory (March 1999)

WPS 2. Stiglitz, Joseph: Promoting Competition in Telecommunications (March 1999)

WPS 3. Chisari, Omar, Antonio Estache, y Carlos Romero: Winners and Losers from Utility Privatization in Argentina: Lessons from a General Equilibrium Model (March 1999)

WPS 4. Rodríguez Pardina, Martín y Martín Rossi: Efficiency Measures and Regulation: An Illustration of the Gas Distribution Sector in Argentina (April 1999)

WPS 5. Rodriguez Pardina, Martín Rossi and Christian Ruzzier: Consistency Conditions: Efficiency Measures for the Electricity Distribution Sector in South America (June 1999)

WPS 6. Gordon Mackerron: Current Developments and Problems of Electricity Regulation in the European Union and the United Kingdom (November 1999)

WPS 7. Martín Rossi: Technical Change and Efficiency Measures: The Post-Privatisation in the Gas Distribution Sector in Argentina (March 2000)

WPS 8. Omar Chisari, Martín Rodriguez Pardina and Martín Rossi: The Cost of Capital in Regulated Firms: The Argentine Experience (May 2000)

WPS 9. Omar Chisari, Pedro Dal-Bó and Carlos Romero: High Tension Electricity Network Expansions in Argentina: Decision Mechanisms and Willingness-to-Pay Revelation (May 2000).

WPS 10. Daniel A. Benitez, Antonio Estache, D. Mark Kennet, And Christian A. Ruzzier. Potential Role of Economic Cost Models in the Regulation of Telecommunications in Developing Countries (August 2000).

WPS 11. Martín Rodríguez Pardina and Martín Rossi. Technical Change and Catching-up: The Electricity Distribution Sector in South America (November 2000).

WPS 12. Martín Rossi and Iván Canay. Measuring Inefficiency in Public Utilities: Does the Distribution Matter? (April, 2001).

WPS 13. Quesada, Lucía. Network Competition and Network Regulation (July, 2001).

WPS 14. ROSSI, MARTÍN AND CHRISTIAN RUZZIER: REDUCING THE ASYMMETRY OF INFORMATION THROUGH THE COMPARISON OF THE RELATIVE EFFICIENCY OF SEVERAL REGIONAL MONOPOLIES (JULY 2001).

WPS 15. Ferro, Gustavo: Political Risk and Regulatory Risk: Issues in Emerging Markets Infrastructure Concessions (August, 2001).